12/14/87 RS650-2

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

NO. 47B
December 18, 1987

IN THIS ISSUE:

Takeshita's High-Stakes U.S. Visit 1

Takeshita Announces Asean Fund 3

Dollar Sinks And Yen Soars 4

Japan Joins In Landmark International Bank Agreement 5

Congress Lashes Out On Kansai 6

Agricultural Imports: Tough Choices For Tokyo 8

Takeshita's High-Stakes U.S. Visit

The month-old government of Noboru Takeshita is already facing potential political difficulties at home, giving his mid-January trip to the United States more significance than was originally expected. The prime minister suffered his first drop in the public opinion polls even before having a serious opportunity to affect policies in Tokyo. While the dip is not significant and other governments have witnessed similar popularity declines in their early months, it appeared surprisingly quickly. This suggests that voters may have become more skeptical about the new premier and will be less tolerant of his administration should it face a serious test during the coming year.

The problems involve both old and new issues. An old one is tax reform, which threatened to dissolve the Nakasone government last spring. The Liberal Democratic Party has modified its position on the subject over the past several months, but still considers it a major policy objective. Voters know instinc-

Dollar Sinks And Yen Soars

The yen crashed through another barrier, rising above 130 yen to the dollar for the first time on December 10. In mid-October, prior to the stock market debacle, its value had been close to 150 yen to the dollar. Since early 1985 the dollar has lost more than half its value relative to the yen.

The strong currency is bad news for Japanese exporters. While profits had been rising recently, they had not recovered to the levels reached before the yen began its rapid ascent. The speed of the most recent rise, with a 13 percent increase against the dollar since the end of September, complicates planning for Japanese companies, especially those that used Y130=$1.00 as a benchmark.

The dollar's latest plunge began immediately after the Commerce Department released October's unexpectedly disastrous trade figures. The markets had been bracing for the new numbers for some time, especially after the release of September's figures, which were also an unpleasant surprise and presaged the stock market collapse on October 19. Market analysts see negative trade figures as evidence that the dollar has to fall further to bring trade closer to balance. The markets apparently decided it was unlikely that the Federal Reserve Board would choose to fight the trade deficit by tightening the money supply, a move that might be expected to increase net capital inflows, demand for dollars, and the value of the dollar. This course of action, which has been forcibly argued by the British, would increase the likelihood of an election-year recession.

A few hours before the U.S. trade statistics for October were announced, Tokyo had released its November trade figures, which almost got lost in the confusion. Arguably more important since they are more current, the data showed a 36 percent year-to-year drop in Japan's dollar-denominated trade surplus. These data seem to suggest that the strong yen of recent months is having an effect: imports are strong and exports are sluggish. If anything, the reaction in currency markets should have been a weaker yen. Instead, in the markets then open in Tokyo, London and Hong Kong, traders just yawned, waiting to be jolted awake by the news from Washington.

The markets' differing reactions to the two sets of figures reflect in part the reality that the United States and Japan do not just trade with each other, important as that trade is. If trade were stictly bilateral the Japanese figures should be more important, being more current. In fact, each nation has other partners and other exchange rates: a big drop in Japan's November surplus does not necessarily mean we will see a big drop in the U.S. trade deficit for the same month when Washington releases its figures a month from now. Nor is the dollar's drop quite the same thing as the yen's rise. As the table below shows, in both the period since the Plaza Accord (see JEI Report No. 38B, October 4, 1985) and since just before the stock market crash, the yen has been strong against the dollar and the Korean won, but almost stable against the German mark.

Changes in the Yen, September 1985 - Mid-December 1987

	October 1, 1985- December 12, 1987	October 1, 1987- December 12, 1987
German mark (DM)	+3.3	+1.6
Korean won	+51.8	+13.6
U.S. dollar	+88.6	+15.0

The relative weakness of the yen against the mark (and other European currencies) suggests that the recent turmoil is more a result of a weak dollar than a strong yen. The strength of the yen against Asian currencies, several of which are closely tied to the dollar, suggests that much of any further improvement in Japan's trade figures may come from increased imports from Asia. In September, the latest month for which figures are available, about 25 percent of Japanese imports came from the United States, but 14 percent came from the "Four Tigers" -- South Korea, Taiwan, Hong Kong and Singapore. Imports from these countries have been sharply higher in recent months. While the dollar's drop might increase the share of Japan's imports from the United States, the dynamic economies of East Asia are likely to benefit even more, especially if their currencies continue to be weak against the yen.

Douglas Ostrom

Japan Joins In Landmark International Bank Agreement

In the not so distant past, individual governments around the world decided independently how to regulate their financial institutions. But now, the Bank for International Settlements has announced a proposal to establish uniform capital adequacy ratios for the world's banks. This initiative, based on discussions among the financial leaders of the world's leading industrial powers, is potentially of great significance for the international competitiveness of the financial institutions here, in Japan and in Europe.

Capital adequacy ratios are one measure of a bank's financial health: a larger ratio means a larger cushion against loss (see JEI Report No. 32B, August 21, 1987). Regulators set minimum capital adequacy ratios to reduce the chances of bank failure, but having to maintain a minimum ratio can mean reduced profits for banks.

Japan dominates the ranks of global banking if size is measured by assets denominated in dollars, with 12 of the world's 20 largest institutions. Japanese banks have a low ratio of capital to total assets, generally reported to be in the range of 2.5 to 3 percent. U.S. banks average around 5 percent, although the second largest, Bank of America, has a ratio of only 2.39 percent. Some interpretations of Japanese dominance point to these low capital requirements. If this analysis is correct, the proposed regulations will remove that advantage.

The ratio refers to what is known as "core capital," which would be raised to 4 percent for banks worldwide under the BIS proposal. But core capital does not reflect so-called hidden reserves, such as appreciated assets, which are important for Japanese banks. Tokyo monetary authorities pressed for their inclusion in the formula and were partly successful; 45 percent of hidden reserves will be added to both capital and assets for purposes of a second, more inclusive, capital ratio. This ratio now averages about 5.5 percent for Japanese banks, but under the new regulations they will have to raise it to 8 percent by 1992.

The new requirements pose difficult choices for Japanese banks. For example, if they retain their present loan margins, even though earnings on assets remain unchanged, the banks will become less profitable as measured by